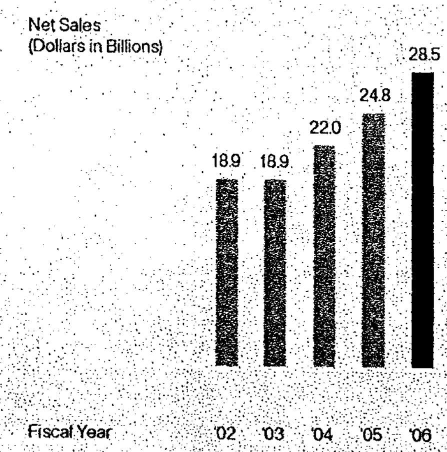
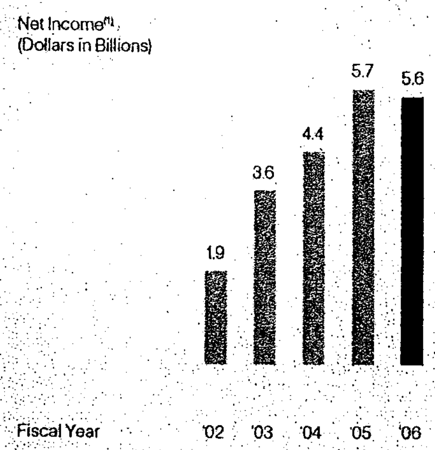
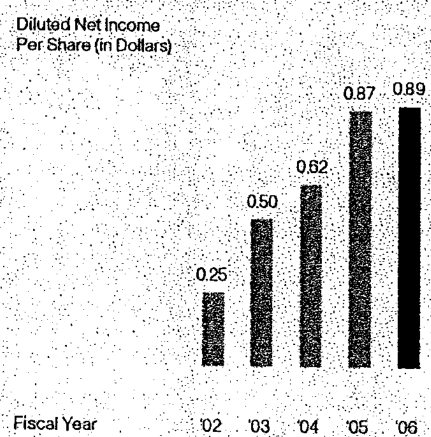
EXHIBIT B

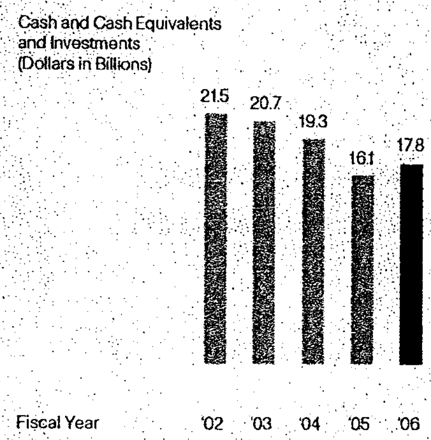
Welcome to the Human Network

Financial Highlights









Consolidated Statements of Operations Data
(in millions, except per-share amounts)

Years Ended	July 29, 2006	July 30, 2005	July 31, 2004
Total net sales	$28,484	$24,801	$22,045
Income before provision for income taxes and cumulative effect of accounting change	$ 7,633	$ 8,036	$ 6,992
Net income[1]	$ 5,580	$ 5,741	$ 4,401
Net income per share—diluted	$ 0.89	$ 0.87	$ 0.62

Consolidated Balance Sheets Data
(in millions)

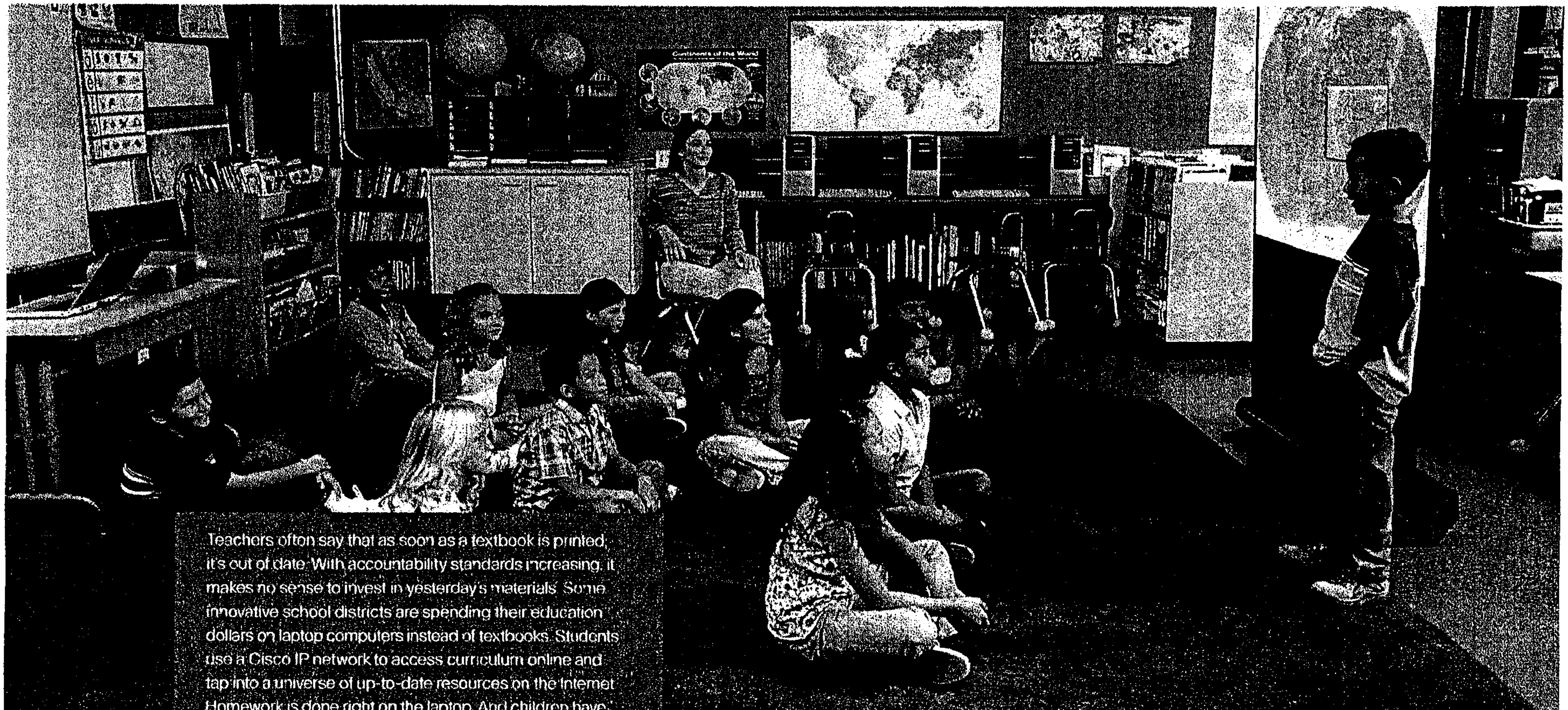
	July 29, 2006	July 30, 2005	July 31, 2004
Cash and cash equivalents and investments	$17,814	$16,055	$19,267
Total assets	$43,315	$33,883	$35,594
Shareholders' equity	$23,912	$23,174	$25,826

(1) Net income for fiscal 2006 included stock-based compensation expense under SFAS 123(R) of $836 million, net of tax. See note 1 on page 18.

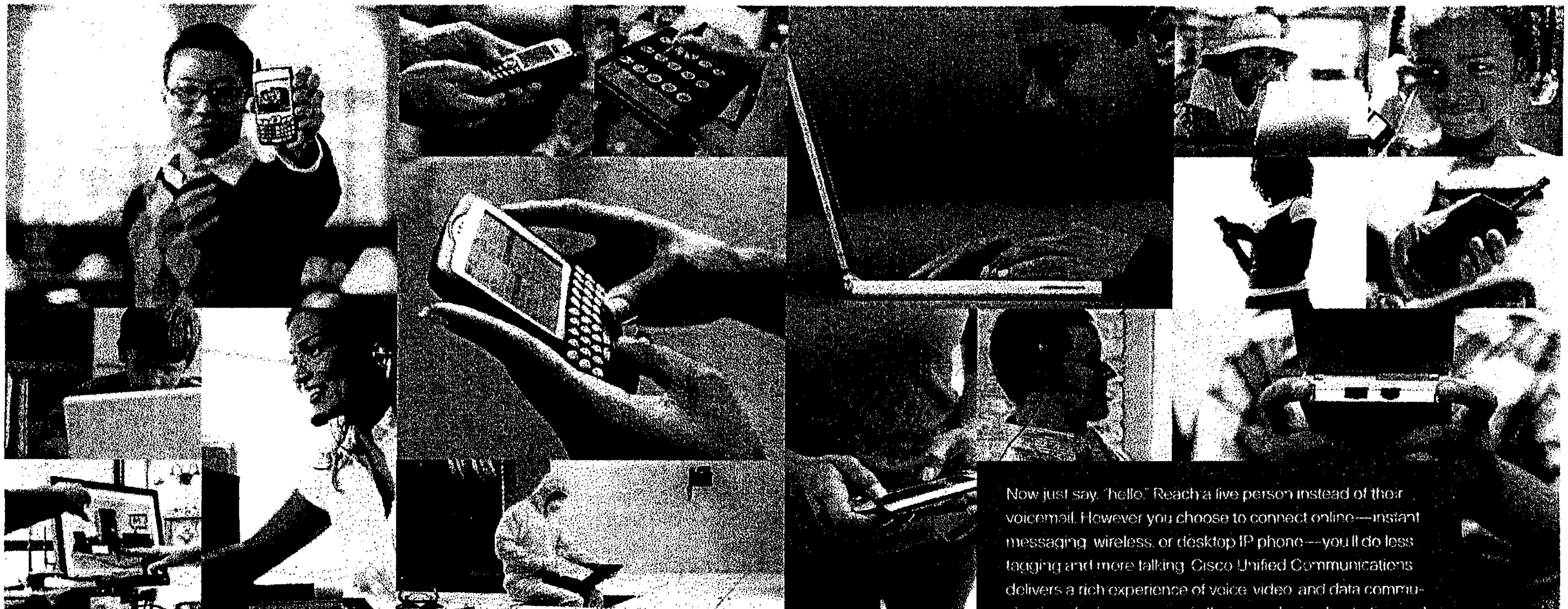
Wonderful things are happening. Cisco is changing the way we work, live, play, and learn. We believe the network is the source for experiencing this change. And it isn't just a network of computers, it's a network of people. A network full of potential; a gateway to new life experiences. A network of human connections. Because we believe we are more powerful together than we ever could be apart. Welcome to the human network.

Cartoons on the phone. Mozart in the shower. Stock ticker in the kitchen.

Laptop = school book.



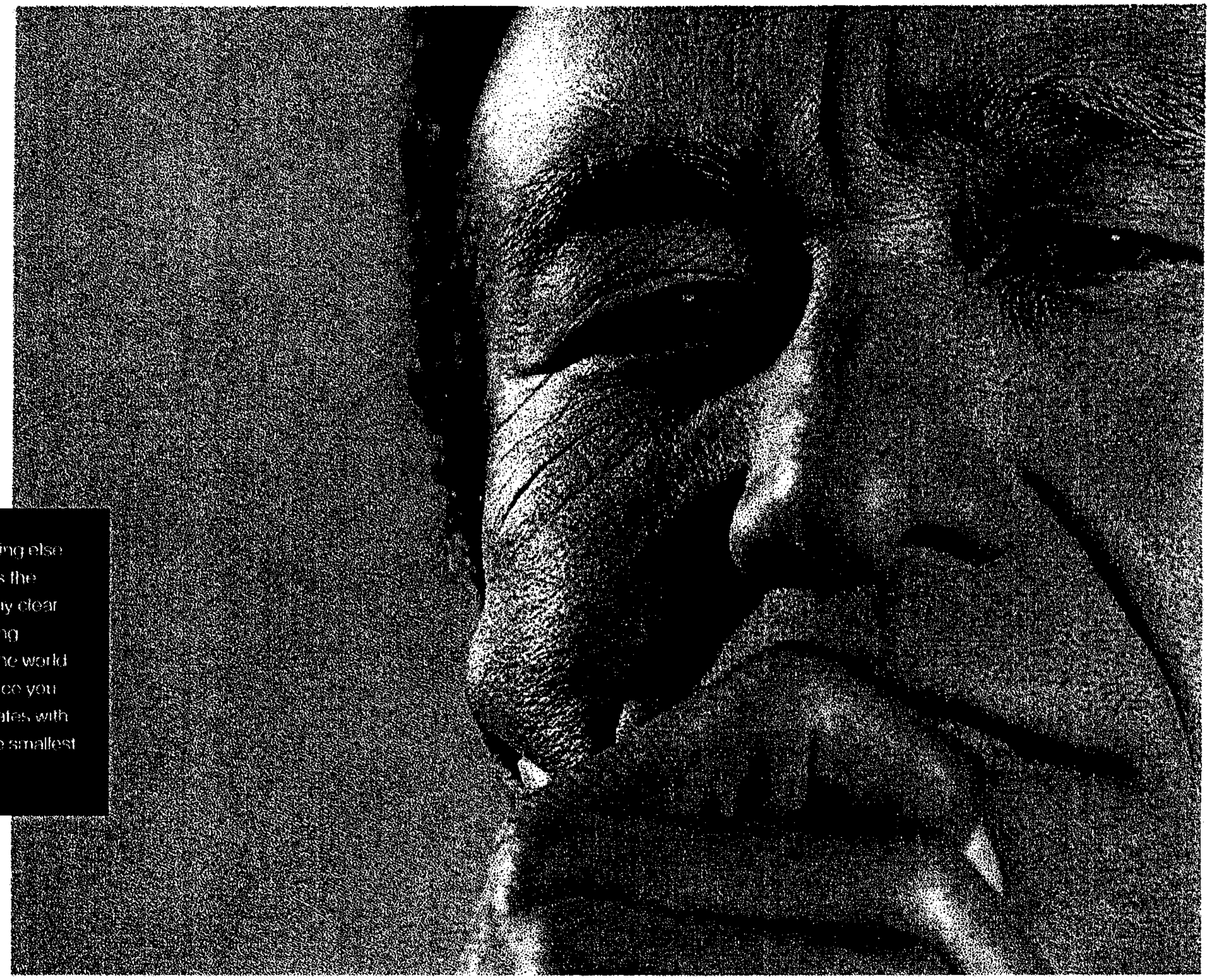
Teachers often say that as soon as a textbook is printed, it's out of date. With accountability standards increasing, it makes no sense to invest in yesterday's materials. Some innovative school districts are spending their education dollars on laptop computers instead of textbooks. Students use a Cisco IP network to access curriculum online and tap into a universe of up-to-date resources on the Internet. Homework is done right on the laptop. And children have connections to other classrooms—and to experiences from around the world.



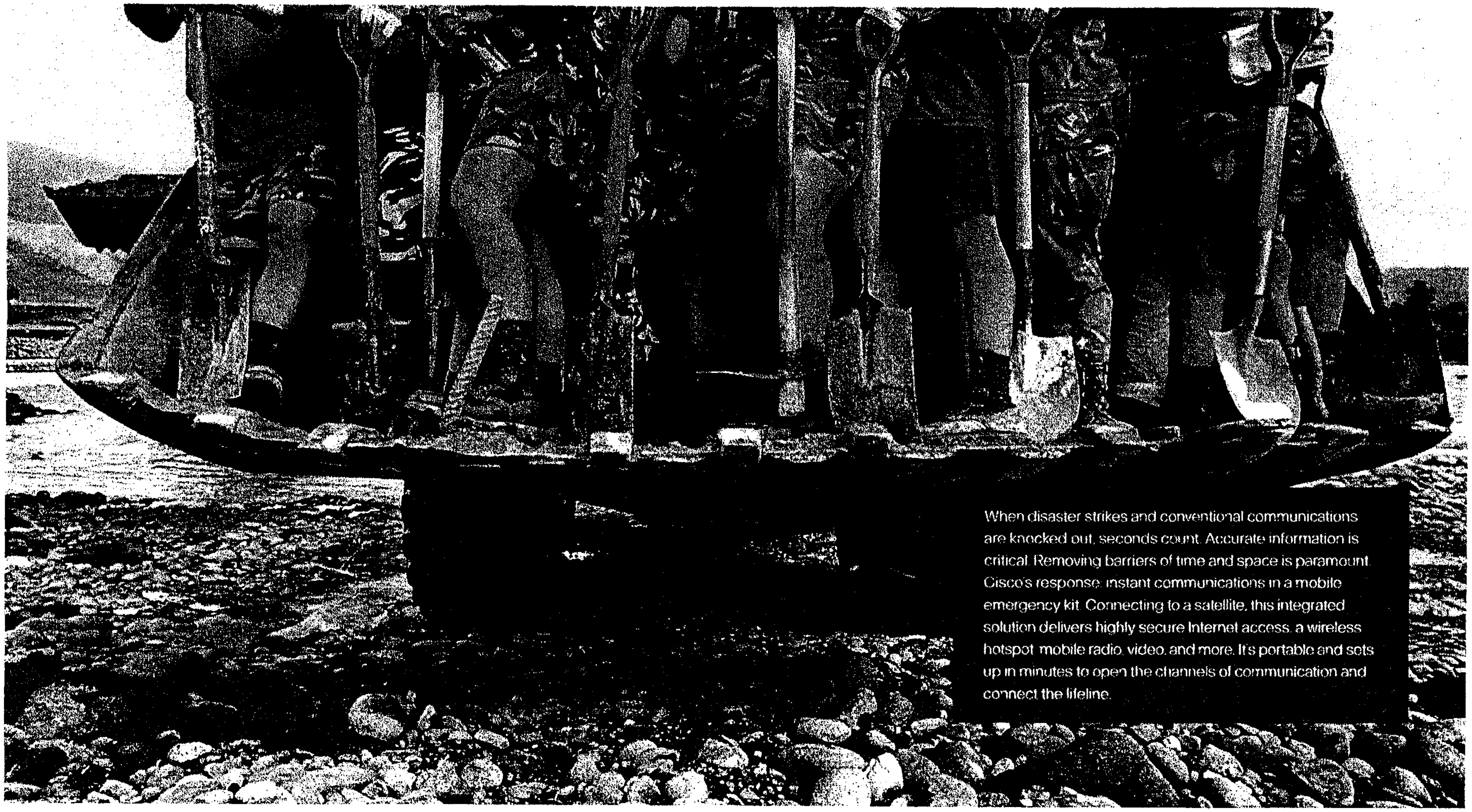
Now just say, "hello." Reach a live person instead of their voicemail. However you choose to connect online—instant messaging, wireless, or desktop IP phone—you'll do less tagging and more talking. Cisco Unified Communications delivers a rich experience of voice, video, and data communications for businesses of all sizes, reducing frustration and boosting productivity. And that sounds good in any language.

More Guten Tag, less phone tag.

The eyebrow is now an advanced digital business communications tool.



Same with the hand. And the shoulder. And everything else that speaks body language. Cisco TelePresence is the closest thing to teleporting. Life-size screens display clear images, with no delay or fuzziness. So you can bring customers, associates, and suppliers from around the world into your conference room—with no jet lag. And once you see and hear each other, TelePresence communicates with more than just words. Because sometimes, even the smallest gesture can speak volumes.



Open box, save lives.

Fiscal 2006 was a record year for Cisco in many ways. We reported record financial results for the year, and we continue to believe that Cisco is poised for taking advantage of market transitions in unique ways. Our record results are due in part to our successful implementation of our strategy, given our vision of how the communications and IT industry would evolve. As intelligence moves throughout the network, the network is becoming the platform that enables most forms of communications and IT.

Vision: Product Innovation

We believe Cisco's leadership is dependent upon three major factors. First, a vision of how the industry will evolve. Second, the strategy Cisco will employ to gain leadership, based upon that vision. And third, our effectiveness in executing on this strategy, as measured by such factors as product leadership, market share gains, and leadership in our customer segments.

To Cisco, vision means the ability to broadly anticipate how the communications and IT market will evolve and understand how the network drives this evolution. We believe the network will change the way the world works, lives, plays, and learns, and that the network will have intelligence distributed throughout it. We see, as the market plays out, that the network will literally become the platform for all of life's experiences by delivering applications and services to our customers and by enabling greater productivity, new business models, and expanded forms of entertainment.

Internet traffic continues to grow, driven in part by the rapid expansion of video traffic over the network. Our successful acquisition of Scientific Atlanta provided Cisco with the technology, capabilities, and talent that help to complete the "quad play" offering of data, voice, and video, with mobility. Today, we address the growing demand for networked video with expertise and a unique understanding of the functionality requirements of the underlying network, which we believe are unmatched by our competitors. In fiscal 2006, we enhanced our position as a strategic business partner for service provider, enterprise, and commercial businesses of all sizes, as well as consumer customers. Cisco has the vision and tools to integrate the business and technology architectural approaches for these networks.

Our technology architectural play with the convergence of Layers 1 through 7 of the OSI stack continues to gain traction and mindshare. For example, customers understand the leadership, total cost of ownership, flexibility, and investment protection advantages they receive when they install a Cisco switch, which is designed to allow them to easily and cost-effectively add market-leading voice, data, security, wireless, and other capabilities to their existing Cisco networks. This innovation strategy is a powerful differentiator versus our competitors, who are usually present in only one or two product categories or customer segments, and often do not integrate their products from an architectural perspective.

John T. Chambers, President and Chief Executive Officer

Our long-time commitment to ongoing research and development (R&D) is the basis for Cisco's innovation. In fiscal 2006, we invested more than $4 billion in R&D. More importantly, the investments we made three to five years ago are the foundation for the growth Cisco experienced this fiscal year. Of particular interest in fiscal 2006 was the service provider acceptance and business momentum of our CRS-1 Carrier Routing System. Our unified communications advanced technology, formerly enterprise IP communications, has positioned Cisco as the market share leader in the enterprise voice marketplace. Storage, another of our advanced technologies, experienced revenue growth of approximately 50 percent on a year-over-year basis. Cisco also announced enhancements to our core routing and switching product lines, introduced three new advanced technologies, and continued development on several emerging technologies. We expect to continue our investment in R&D in fiscal 2007 to support our vision of innovation.

Balanced Strategy: Customer Market Segments and Geographies

Cisco's strategy is built around four basic principles. First, our ability to identify market transitions and position Cisco for those transitions based upon feedback primarily from our customers. Second, our unique approach to this market, taking an architectural perspective, as opposed to just thinking about individual products. Third, our balanced business and technology implementation. And fourth, careful collaboration and teamwork as we execute across what we define as a multiple-dimension chess game, including innovation, products, customer segments, and geographies, enabled by services.

Our balanced approach to the industry in terms of our four customer segments (enterprise, service provider, commercial, and consumer), core and advanced technologies, and our five key geographic theaters continues to work very well. With the acquisition of Scientific Atlanta, we gained systems integration expertise that allowed us to service a segment of the global service provider market we hadn't been able to fully reach before. The acquisition also brought us an expanded consumer offering. Scientific Atlanta is a leading provider of high-end set-top boxes to view high-definition digital video in addition to standard programming. We believe these devices drive increased demand for bandwidth on service provider networks, making this a win for Cisco in both the service provider and consumer segments of the market.

In fiscal 2006, we also saw previously unmatched acceptance of our products in the commercial market segment, making it our fastest-growing market segment. We define a commercial business as generally one with less than 1,000 employees. Small to medium-sized businesses and retail chains are some examples of this type of market segment. It is exciting to watch this segment begin to embrace networking and unlock the power and efficiency of their business network investment. Again, we believe that Cisco will be a long-term, trusted partner for this segment, and we look forward to helping these businesses grow to their fullest potential.

Cisco's business is made up of five distinct theaters, or geographical regions. These include the United States and Canada, European Markets, Emerging Markets, Asia Pacific, and Japan. For fiscal 2006, we reorganized our sales theaters and added the Emerging Markets theater in order to take advantage of the growth potential of these countries. We met with government leaders around the world in countries such as India, China, Germany, Saudi Arabia, and Russia. Our conversations centered around how Cisco could help their countries develop a stronger economy through Internet access to education, healthcare, and business opportunities. As these countries begin to deploy Internet solutions, they look to Cisco as a partner and resource vital to their success. As a result, product revenue in Cisco's Emerging Markets theater grew 38 percent on a year-over-year basis—the highest growth percentage of all five theaters. Growth in Emerging Markets is the truest example of the power of the network now.

Execution: Consistency, Transparency, Trust

We view execution as achieving both financial success in a quarter or year, and also leadership from a product and market segment perspective. Our goal is to lead in implementation from a technology point of view as Layers 1 through 7 of the OSI stack converge in a way that makes routing, switching, data center, security, wired, wireless, and home networking come uniquely together. We expect to lead the market in implementing the quad play everywhere—transforming how you experience entertainment, how you work, and the ways you communicate and interact throughout your home, your business, and even your transportation.

In fiscal 2006, Cisco achieved outstanding financial results. Total revenue for fiscal 2006 was a record $28.5 billion, an increase of approximately 15 percent over fiscal 2005 revenue of $24.8 billion. We believe our revenue growth was the result of market share gains in many product categories, as well as the addition of Scientific Atlanta. Of total revenue, $23.9 billion was related to product revenue and $4.6 billion was related to service revenue.

To address the growth in new markets, we added approximately 11,500 employees on a net basis throughout the year, including almost 8,000 as a result of the acquisition of Scientific Atlanta. Cisco continued its tradition of striving for profitable growth. Despite the added headcount expense, we continued to hold margins within our plan. Total gross margin for fiscal 2006 was over 65 percent. Fiscal year operating margin was approximately 25 percent, making Cisco one of the most profitable companies in the technology networking sector.

Net income was $5.6 billion or approximately 20 percent of revenue. Earnings per share on a fully diluted basis for fiscal 2006 were $0.89. If we had included the newly required Statement of Financial Accounting Standards No. 123, or SFAS123, expense previously disclosed in our footnotes, fiscal 2005 EPS would have been $0.71, representing a 25 percent increase over the prior year had the expense been required then. Cisco generated $7.9 billion of cash from operations and used $8.3 billion to repurchase 435 million shares of stock.

We diversified our capital base with the issuance of $6.5 billion of long-term debt. Our inaugural debt issuance was rated favorably by the ratings agencies and overwhelmingly received by the market. We believe this can be attributed to the underlying strength of Cisco as a whole. Proceeds from the debt issuance were used to purchase Scientific Atlanta and for other general corporate purposes. We believe this was a sound financing decision for Cisco.

We are proud of Cisco's consistency and transparency in financial reporting and execution in operations. We also continue to pursue success and trust as a corporate citizen. Cisco's products promote collaboration and communication of information that is used not only to power businesses, but to modernize governments, support education, and foster economic development as well. We partner with Lawrence Berkeley National Laboratory to research innovations in product design that enhance energy efficiency. Our product design and manufacturing teams seek ways to cut emissions and increase the recyclable nature of our products. Global connections via the Internet remind us that we all inhabit one world. We believe in protecting it as best we can.

John P. Morgridge, Chairman of the Board

Cisco is also committed to education. Our company supports Networking Academy programs in more than 160 countries, with approximately 10,000 academies and over 430,000 students. Students in high schools, technical schools, colleges, and community organizations learn hands-on networking skills to prepare for the workforce of today and the future. The Jordan Education Initiative, spearheaded by Cisco in partnership with the World Economic Forum and several other organizations, continued its momentum of expanding its interactive e-curriculum-based education programs by moving into new geographic areas such as Egypt and India. The education initiatives in the Mississippi and Louisiana school systems after Hurricane Katrina are rebuilding schools for the 21st century. These are all examples of how technology has the power to change the way people work, live, play, and learn. More importantly, it can actually improve lives.

Looking Back

Looking at all that was achieved in fiscal 2006, it is hard to imagine the humble beginnings of Cisco. When John Morgridge became president and CEO in 1988, Cisco's annual revenues were $5 million, less than 0.02 percent of our annual revenues today. We were a competitor in the single product category of routing, and our entire corporation employed only 29 employees. At the time, we were thrilled to have a customer, any customer, visit our modest offices in Menlo Park.

Today, we are a global company with a strong and diverse product line and annual revenues approaching $30 billion. We are proud of our position as the number 1 or number 2 competitor in almost every technology segment in which we compete. In the last year, our San Jose headquarters was visited by hundreds of business, government, and technology leaders, including U.S. President George Bush and Britain's Prime Minister Tony Blair. Cisco's operations on a global basis now reach geographies that we considered previously unreachable. We employ approximately 50,000 of the best and brightest talent in the world. We continue to grow our technological capabilities to meet new challenges and state-of-the-art applications.

At this year's annual meeting in November 2006, John Morgridge will step down from his day-to-day responsibilities as chairman of the board. We thank John for his many years of service to Cisco, and for his invaluable contributions to our business as well as the fundamental nature of our culture. When you look at Cisco's success, John Morgridge has played a key role in making that happen, including the business results, management evolution, and the development of a distinctive corporate culture. He will continue to serve as chairman emeritus and lead the Cisco Systems Foundation. At that time, John Chambers will assume the role of chairman and CEO. On behalf of the board of directors, it has been our distinct honor to serve at the request of the shareholders. We wish to thank our customers, partners, employees, and shareholders for their continued trust, confidence, and support as we move into the next exciting phase of Cisco's history.

John T. Chambers

John T. Chambers
President and Chief Executive Officer

John P. Morgridge

John P. Morgridge
Chairman of the Board

Reports of Management

Statement of Management's Responsibility

Cisco's management has always assumed full accountability for maintaining compliance with our established financial accounting policies and for reporting our results with objectivity and the highest degree of integrity. It is critical for investors and other users of the Consolidated Financial Statements to have confidence that the financial information that we provide is timely, complete, relevant, and accurate. Management is responsible for the fair presentation of Cisco's Consolidated Financial Statements, prepared in accordance with generally accepted accounting principles (GAAP), and has full responsibility for their integrity and accuracy.

Management, with oversight by Cisco's Board of Directors, has established and maintains a strong ethical climate so that our affairs are conducted to the highest standards of personal and corporate conduct. Management also has established an effective system of internal control over financial reporting. Cisco's policies and practices reflect corporate governance initiatives that are compliant with the listing requirements of NASDAQ and the corporate governance requirements of the Sarbanes-Oxley Act of 2002.

We are committed to enhancing shareholder value and fully understand and embrace our fiduciary oversight responsibilities. We are dedicated to ensuring that our high standards of financial accounting and reporting as well as our underlying system of internal controls are maintained. Our culture demands integrity and we have the highest confidence in our processes, our internal controls, and our people, who are objective in their responsibilities and who operate under the highest level of ethical standards.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Cisco. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management (with the participation of the principal executive officer and principal financial officer) conducted an evaluation of the effectiveness of Cisco's internal control over financial reporting based on the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that Cisco's internal control over financial reporting was effective as of July 29, 2006. Management's assessment of the effectiveness of Cisco's internal control over financial reporting as of July 29, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

John T. Chambers

John T. Chambers
President and Chief Executive Officer
September 15, 2006

Dennis D Powell

Dennis D. Powell
Senior Vice President and Chief Financial Officer
September 15, 2006

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Cisco Systems, Inc.:

We have completed integrated audits of Cisco Systems, Inc.'s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of July 29, 2006, and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated Financial Statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of shareholders' equity and of cash flows appearing on pages 43 to 46 present fairly, in all material respects, the financial position of Cisco Systems, Inc. and its subsidiaries at July 29, 2006 and July 30, 2005, and the results of their operations and their cash flows for each of the three years in the period ended July 29, 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company changed its method of accounting for share-based compensation in 2006. As also discussed in Note 2 to the consolidated financial statements, the Company changed its method of classification of its investments in 2006. As discussed in Notes 2 and 3 to the consolidated financial statements, effective January 24, 2004, the Company adopted Financial Accounting Standards Board Interpretation No. 46(R), "Consolidation of Variable Interest Entities."

Internal Control Over Financial Reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of July 29, 2006 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of July 29, 2006, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

San Jose, California
September 15, 2006

Selected Financial Data

Five Years Ended July 29, 2006 (in millions, except per-share amounts)

The following selected financial data should be read in conjunction with the Consolidated Financial Statements and related notes which appear on pages 43 to 78 of this Annual Report:

	July 29, 2006	July 30, 2005	July 31, 2004	July 26, 2003	July 27, 2002
Net sales	$28,484	$24,801	$22,045	$18,878	$18,915
Net income	$ 5,580[1]	$ 5,741	$ 4,401[2]	$ 3,578	$ 1,893
Net income per share—basic	$ 0.91	$ 0.88	$ 0.64	$ 0.50	$ 0.26
Net income per share—diluted	$ 0.89	$ 0.87	$ 0.62	$ 0.50	$ 0.25
Shares used in per-share calculation—basic	6,158	6,487	6,840	7,124	7,301
Shares used in per-share calculation—diluted	6,272	6,612	7,057	7,223	7,447
Cash and cash equivalents and investments	$17,814	$16,055	$19,267	$20,652	$21,456
Total assets	$43,315	$33,883	$35,594	$37,107	$37,795
Long-term debt	$ 6,332	$ —	$ —	$ —	$ —

(1) Net income for fiscal 2006 included stock-based compensation expense under Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") of $836 million, net of tax, which consisted of stock-based compensation expense of $756 million, net of tax, related to employee stock options and employee stock purchases and stock-based compensation expense of $80 million, net of tax, related to acquisitions and investments. There was no stock-based compensation expense related to employee stock options and employee stock purchases under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), prior to fiscal 2006 because the Company did not adopt the recognition provisions of SFAS 123. See Note 10 to the Consolidated Financial Statements.

(2) Net income for fiscal 2004 included a noncash charge for the cumulative effect of accounting change relating to stock-based compensation expense of $567 million, net of tax, related to the adoption of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" ("FIN 46(R)"). See Note 3 to the Consolidated Financial Statements.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "continues," "may," variations of such words and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those identified below, as well as on the inside back cover of this Annual Report to Shareholders and under Part I, Item 1A. Risk Factors and elsewhere in our Annual Report on Form 10-K. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Overview

We sell Internet Protocol (IP)-based networking and other products and services related to the communications and information technology industry that address a wide range of customers' business needs, including improving productivity, reducing costs, and gaining a competitive advantage. Our corresponding technology focus is on delivering networking products and solutions that simplify customers' infrastructures, offer integrated services, and are highly secure. Our products and services help customers build their own network infrastructures that support tools and applications that allow them to communicate with key stakeholders, including customers, prospects, business partners, suppliers, and employees. Our product offerings fall into several categories: our core technologies, routing and switching; advanced technologies; and other products. In addition to our product offerings, we provide a broad range of service offerings, including technical support services and advanced services. Our customer base spans virtually all types of public and private agencies and businesses, comprising large enterprise companies, service providers, commercial, and consumer customers.

In fiscal 2006, we continued to focus on three long-term financial priorities:

- Seek profitable growth opportunities
- Achieve profitability targets and improve productivity
- Increase shareholder value

Our results for fiscal 2006 reflected increases in net sales, net income, and net income per share from fiscal 2005, if the effect of pro forma stock-based compensation reported in Note 10 to our Consolidated Financial Statements for fiscal 2005 were included in the calculation of net income and net income per share for fiscal 2005. In February 2006, we completed the acquisition of Scientific-Atlanta, Inc. ("Scientific-Atlanta"), a provider of set-top boxes, end-to-end video distribution networks, and video integration systems. With this acquisition, we have added video to the convergence of data, voice, and mobility technologies which enables us to be a stronger strategic business partner with our service provider customers. Fiscal 2006 results include Scientific-Atlanta's contribution of $989 million in net sales for the five-month period subsequent to the acquisition date. We have continued to achieve a good balance in year-over-year revenue growth from our geographic segments, customer markets, and product families. Revenue increased in our four largest geographic theaters from fiscal 2005, with the increase occurring primarily in the United States and in the Emerging Markets theater. Sales of our advanced technologies increased by 34% over fiscal 2005 in part due to the acquisition of Scientific-Atlanta, which increased sales of advanced technologies by 19%, and also due to strength in unified communications, wireless technology, storage area networking, and security. Our sales of optical networking products will no longer be included in our advanced technologies product category beginning in fiscal 2007 and instead will be included in the other product category. Both our routing and switching revenue increased by approximately 9% over fiscal 2005.

For fiscal 2006, our gross margin percentage decreased compared to fiscal 2005. The decrease in gross margin percentage from fiscal 2005 was primarily related to the acquisition of Scientific-Atlanta, whose business model has a lower gross margin percentage than the Cisco model. Other factors contributing to the decrease in the gross margin percentage were the sales mix of certain switching and routing products, and the effect of stock-based compensation expense under SFAS 123(R). These factors were partially offset by lower manufacturing costs related to lower component costs and higher volume. Operating expenses increased year-over-year due primarily to increased sales and engineering headcount-related expenses and the effect of our adoption of SFAS 123(R).

During fiscal 2006, we focused particular attention on five key areas: the commercial market segment; additional sales coverage; growing and expanding our advanced technologies; evolving our support model; and expanding our presence in the Emerging Markets theater. In addition to continuing our focus on these five key areas, going forward, we expect to focus on next-generation service provider network build-outs, strengthening our product offerings in the consumer market, and providing more comprehensive solutions to our customers as they employ Internet solutions. Indicative of the opportunities in our markets, we continue to encounter price-focused competition, including competitors from Asia, and in particular China.

During fiscal 2006, we generated cash flows from operations of $7.9 billion. Our cash and cash equivalents and investments were $17.8 billion at the end of fiscal 2006, compared with $16.1 billion at the end of fiscal 2005. We raised $6.5 billion of cash in a debt offering and used $5.0 billion for the Scientific-Atlanta acquisition, net of cash, cash equivalents, and investments acquired. We used $8.3 billion of cash to repurchase 435 million shares of our common stock during fiscal 2006. Days sales outstanding in accounts receivable at the end of fiscal 2006 were 38 days, compared with 31 days at the end of fiscal 2005. While our inventory balance was $1.4 billion at the end of fiscal 2006 compared to $1.3 billion at the end of fiscal 2005, our annualized inventory turns increased to 8.5 in the fourth quarter of fiscal 2006 as compared with 6.6 in the fourth quarter of fiscal 2005. The inventory balances and turns for the fourth quarter of fiscal 2006 reflected increased sales, the initial implementation of the lean manufacturing model, and the addition of Scientific-Atlanta inventory.

Beginning in fiscal 2006, we adopted SFAS 123(R) on a modified prospective basis. The following table provides a comparison of net income, if the effect of pro forma stock-based compensation expense as disclosed in the notes to the Consolidated Financial Statements were included for fiscal 2005 (in millions, except per-share amounts):

Years Ended	July 29, 2006	July 30, 2005
Net income—as reported for fiscal 2005(1)	N/A	$ 5,741
Stock-based compensation expense related to employee stock options and employee stock purchases	$(1,050)	(1,628)
Tax benefit	$ 294	594
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax(2)	$ (756)	(1,034)
Net income, including the effect of stock-based compensation expense(3)	$ 5,580	$ 4,707
Diluted net income per share—as reported for fiscal 2005(1)	N/A	$ 0.87
Diluted net income per share, including the effect of stock-based compensation expense(3)	$ 0.89	$ 0.71

(1) Net income and net income per share prior to fiscal 2006 did not include stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123 because we did not adopt the recognition provisions of SFAS 123.

(2) Stock-based compensation expense prior to fiscal 2006 is calculated based on the pro forma application of SFAS 123 as previously disclosed in the notes to the Consolidated Financial Statements.

(3) Net income and net income per share prior to fiscal 2006 represent pro forma information based on SFAS 123 as previously disclosed in the notes to the Consolidated Financial Statements.

Critical Accounting Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The accounting policies described below are significantly affected by critical accounting estimates. Such accounting policies require significant judgments, assumptions, and estimates used in the preparation of the Consolidated Financial Statements, and actual results could differ materially from the amounts reported based on these policies.

Revenue Recognition

Our products are generally integrated with software that is essential to the functionality of the equipment. Additionally, we provide unspecified software upgrades and enhancements related to the equipment through our maintenance contracts, for most of our products. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, "Software Revenue Recognition," and all related interpretations. For sales of products where software is incidental to the equipment, we apply the provisions of Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" and Staff Accounting Bulletin No. 104, "Revenue Recognition," and all related interpretations. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met.

Contracts, Internet commerce agreements, and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history. When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. The amount of product and service revenue recognized is impacted by our judgment as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence of fair value exists. Changes to the elements in an arrangement and our ability to establish vendor-specific objective evidence for those elements could affect the timing of the revenue recognition. Our total deferred revenue for products was $1.6 billion and $1.4 billion as of July 29, 2006 and July 30, 2005, respectively. Technical support services revenue is deferred and recognized ratably over the period during which the services are to be performed, which is typically from one to three years. Advanced services revenue is recognized upon delivery or completion of performance. Our total deferred revenue for services was $4.1 billion and $3.6 billion as of July 29, 2006 and July 30, 2005, respectively.

We make sales to distributors and retail partners and recognize revenue based on a sell-through method using information provided by them. Our distributors and retail partners participate in various cooperative marketing and other programs, and we maintain estimated accruals and allowances for these programs. If actual credits received by our distributors and retail partners for these programs were to deviate significantly from our estimates, which are based on historical experience, our revenue could be adversely affected.

Allowance for Doubtful Accounts and Sales Returns

Our accounts receivable balance, net of allowance for doubtful accounts, was $3.3 billion and $2.2 billion as of July 29, 2006 and July 30, 2005, respectively. The allowance for doubtful accounts was $175 million, or 5.0% of the gross accounts receivable balance, as of July 29, 2006 and $162 million, or 6.8% of the gross accounts receivable balance, as of July 30, 2005. The allowance is based on our assessment of the collectibility of customer accounts. We regularly review the allowance by considering factors such as historical experience, credit quality, age of the accounts receivable balances, and current economic conditions that may affect a customer's ability to pay.

Our provision for doubtful accounts was $24 million for fiscal 2006. We had no provision for doubtful accounts in fiscal 2005 and our provision for doubtful accounts was $19 million in fiscal 2004. If a major customer's creditworthiness deteriorates, or if actual defaults are higher than our historical experience, or if other circumstances arise, our estimates of the recoverability of amounts due to us could be overstated, and additional allowances could be required, which could have an adverse impact on our revenue.

A reserve for future sales returns is established based on historical trends in product return rates. The reserve for future sales returns as of July 29, 2006 and July 30, 2005 was $80 million and $63 million, respectively, and was recorded as a reduction of our accounts receivable. If the actual future returns were to deviate from the historical data on which the reserve had been established, our revenue could be adversely affected.

Allowance for Inventory and Liability for Purchase Commitments with Contract Manufacturers and Suppliers

Our inventory balance was $1.4 billion and $1.3 billion as of July 29, 2006 and July 30, 2005, respectively. Our inventory allowance was $152 million and $159 million as of July 29, 2006 and July 30, 2005, respectively. We provide allowances for inventory based on excess and obsolete inventories determined primarily by future demand forecasts. The allowance is measured as the difference between the cost of the inventory and market based upon assumptions about future demand and is charged to the provision for inventory, which is a component of our cost of sales. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Our provision for inventory was $162 million, $221 million, and $205 million for fiscal 2006, 2005, and 2004, respectively. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of rapidly changing technology and customer requirements, we could be required to increase our inventory allowances, and our gross margin could be adversely affected. In the third quarter of fiscal 2006, we began the initial implementation of the lean manufacturing model. Inventory management remains an area of focus as we balance the need to maintain strategic inventory levels to ensure competitive lead times with the risk of inventory obsolescence.

In addition, we record a liability for firm, noncancelable, and unconditional purchase commitments with contract manufacturers and suppliers for quantities in excess of our future demand forecasts consistent with our allowance for inventory. As of July 29, 2006, the liability for these purchase commitments was $148 million, compared with $87 million as of July 30, 2005, and was included in other accrued liabilities.

Warranty Costs

The liability for product warranties, included in other accrued liabilities, was $309 million as of July 29, 2006, compared with $259 million as of July 30, 2005. See Note 8 to the Consolidated Financial Statements. Our products are generally covered by a warranty for periods ranging from 90 days to five years, and for some products we provide a limited lifetime warranty. We accrue for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends in the rate of customer cases and the cost to support the customer cases within the warranty period. Overhead cost is applied based on estimated time to support warranty activities.

The provision for product warranties issued during fiscal 2006 and 2005 was $395 million and $411 million, respectively. The decrease in the provision for product warranties was due to lower warranty claims partially offset by higher shipment volume of our products. If we experience an increase in warranty claims compared with our historical experience, or if the cost of servicing warranty claims is greater than the expectations on which the accrual has been based, our gross margin could be adversely affected.

Stock-Based Compensation Expense

On July 31, 2005, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan ("employee stock purchases") based on estimated fair values. Stock-based compensation expense recognized under SFAS 123(R) for fiscal 2006 was $1.1 billion, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases of $1.0 billion, and stock-based compensation expense related to acquisitions and investments of $87 million. For fiscal 2005 and fiscal 2004, stock-based compensation expense of $154 million and $244 million, respectively, was related to acquisitions and investments which we had been recognizing under previous accounting standards. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during fiscal 2005 and fiscal 2004. See Note 10 to the Consolidated Financial Statements for additional information.

Upon adoption of SFAS 123(R), we began estimating the value of employee stock options on the date of grant using a lattice-binomial model. Prior to the adoption of SFAS 123(R), the value of each employee stock option was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial information provided in accordance with SFAS 123. The determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. The use of a lattice-binomial model requires extensive actual employee exercise behavior data and a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, kurtosis, and skewness. The weighted-average estimated value of employee stock options granted during fiscal 2006 was $5.15 per share, using the lattice-binomial model with the following weighted-average assumptions:

	Weighted-Average Assumptions
Expected volatility	23.7%
Risk-free interest rate	4.3%
Expected dividend	0.0%
Kurtosis	4.3
Skewness	(0.62)

We used the implied volatility for two-year traded options on our stock as the expected volatility assumption required in the lattice-binomial model consistent with SFAS 123(R) and SAB 107. Prior to fiscal 2006, we had used our historical stock price volatility in accordance with SFAS 123 for purposes of our pro forma information. The selection of the implied volatility approach was based upon the availability of actively traded options on our stock and also upon our assessment that implied volatility is more representative of future stock price trends than historical volatility. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The dividend yield assumption is based on the history and expectation of dividend payouts. The estimated kurtosis and skewness are technical measures of the distribution of stock price returns, which affect expected employee exercise behaviors that are based on our stock price return history as well as consideration of academic analyses. Because stock-based compensation expense recognized in the Consolidated Statement of Operations for fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period.

Investment Impairments

Our publicly traded equity securities are reflected in the Consolidated Balance Sheets at a fair value of $712 million as of July 29, 2006, compared with $941 million as of July 30, 2005. See Note 6 to the Consolidated Financial Statements. We recognize an impairment charge when the declines in the fair values of our publicly traded equity securities below their cost basis are judged to be other-than-temporary. The ultimate value realized on these equity securities, to the extent unhedged, is subject to market price volatility until they are sold. We consider various factors in determining whether we should recognize an impairment charge, including the length of time and extent to which the fair value has been less than our cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Our ongoing consideration of these factors could result in additional impairment charges in the future, which could adversely affect our net income. Our impairment charge on investments in publicly held companies was $5 million in fiscal 2005. There were no impairment charges on investments in publicly held companies in fiscal 2006 or fiscal 2004.

We also have investments in privately held companies, some of which are in the startup or development stages. As of July 29, 2006, our investments in privately held companies were $574 million, compared with $421 million as of July 30, 2005, and were included in other assets. See Note 4 to the Consolidated Financial Statements. We monitor these investments for impairment and make appropriate reductions in carrying values if we determine an impairment charge is required, based primarily on the financial condition and near-term prospects of these companies. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. Our impairment charges on investments in privately held companies were $15 million, $39 million, and $112 million during fiscal 2006, 2005, and 2004, respectively.

Goodwill Impairments

Our methodology for allocating the purchase price relating to purchase acquisitions is determined through established valuation techniques in the high-technology communications industry. Goodwill is measured as the excess of the cost of acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. We perform goodwill impairment tests on an annual basis and between annual tests in certain circumstances for each reporting unit. The goodwill recorded in the Consolidated Balance Sheets as of July 29, 2006 and July 30, 2005 was $9.2 billion and $5.3 billion, respectively. In response to changes in industry and market conditions, we could be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill. Beginning in fiscal 2006, the reportable segments were changed to the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. As a result, we reallocated goodwill to these reportable segments. There was no impairment of goodwill in fiscal 2006, 2005, and 2004.

Income Taxes

We are subject to income taxes in both the United States and numerous foreign jurisdictions. Significant judgment is required in evaluating our tax positions and determining our provision for income taxes.

During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. We establish reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes and interest will be due. These reserves are established when, despite our belief that our tax return positions are fully supportable, we believe that certain positions are likely to be challenged and may not be fully sustained on review by tax authorities. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. Although we believe our reserves are reasonable, no assurance can be given that the final tax outcome of these matters will not be different from that which is reflected in our historical income tax provisions and accruals. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Significant judgment is also required in determining any valuation allowance recorded against deferred tax assets. In assessing the need for a valuation allowance, we consider all available evidence including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. In the event that we change our determination as to the amount of deferred tax assets that can be realized, we will adjust our valuation allowance with a corresponding impact to the provision for income taxes in the period in which such determination is made.

Our effective tax rates differ from the statutory rate primarily due to acquisition-related costs, stock-based compensation, research and experimentation tax credits, state taxes, and the tax impact of foreign operations. The effective tax rate was 26.9%, 28.6%, and 28.9% for fiscal 2006, 2005, and 2004, respectively. The tax provision rate for fiscal 2006 reflected a benefit of approximately $124 million from the favorable settlement of a tax audit in a foreign jurisdiction. Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets or liabilities, or by changes in tax laws, regulations, accounting principles, or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Loss Contingencies

We are subject to the possibility of various losses arising in the ordinary course of business. We consider the likelihood of loss or impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated. We regularly evaluate current information available to us to determine whether such accruals should be adjusted and whether new accruals are required.

Financial Data for Fiscal 2006, 2005, and 2004

Net Sales

The following table presents the breakdown of net sales between product and service revenue (in millions, except percentages):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	Variance in Percent	July 30, 2005	July 31, 2004	Variance in Dollars	Variance in Percent
Net sales:								
Product	$23,917	$ 20,853	$ 3,064	14.7%	$ 20,853	$ 18,550	$ 2,303	12.4%
Percentage of net sales	*84.0%*	*84.1%*			*84.1%*	*84.1%*		
Service	4,567	3,948	619	15.7%	3,948	3,495	453	13.0%
Percentage of net sales	*16.0%*	*15.9%*			*15.9%*	*15.9%*		
Total	$28,484	$ 24,801	$ 3,683	14.9%	$ 24,801	$ 22,045	$ 2,756	12.5%

As a result of organizational changes, beginning in fiscal 2006, our reportable segments were changed to the following theaters: United States and Canada; European Markets; Emerging Markets; Asia Pacific; and Japan. We have recast our fiscal 2005 and fiscal 2004 geographic theater data to reflect this change in reportable segments to conform to the current year's presentation. Prior to fiscal 2006, we had four reportable segments: the Americas; Europe, the Middle East, and Africa (EMEA); Asia Pacific; and Japan. Net sales, which include product and service revenue, for each theater are summarized in the following table (in millions, except percentages):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	Variance in Percent	July 30, 2005	July 31, 2004	Variance in Dollars	Variance in Percent
Net sales:								
United States and Canada	$15,785	$ 13,298	$2,487	18.7%	$ 13,298	$ 11,631	$ 1,667	14.3%
Percentage of net sales	*55.4%*	*53.6%*			*53.6%*	*52.8%*		
European Markets	6,079	5,692	387	6.8%	5,692	5,278	414	7.8%
Percentage of net sales	*21.4%*	*23.0%*			*23.0%*	*23.9%*		
Emerging Markets	2,476	1,805	671	37.2%	1,805	1,450	355	24.5%
Percentage of net sales	*8.7%*	*7.3%*			*7.3%*	*6.6%*		
Asia Pacific	2,853	2,486	367	14.8%	2,486	2,230	256	11.5%
Percentage of net sales	*10.0%*	*10.0%*			*10.0%*	*10.1%*		
Japan	1,291	1,520	(229)	(15.1)%	1,520	1,456	64	4.4%
Percentage of net sales	*4.5%*	*6.1%*			*6.1%*	*6.6%*		
Total	$28,484	$ 24,801	$3,683	14.9%	$ 24,801	$ 22,045	$ 2,756	12.5%

Management's Discussion and Analysis of Financial Condition and Results of Operations

Net Product Sales by Theater

The following table presents the breakdown of net product sales by theater (in millions, except percentages):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	Variance in Percent	July 30, 2005	July 31, 2004	Variance in Dollars	Variance in Percent
Net product sales:								
United States and Canada	$ 12,601	$10,511	$2,090	19.9%	$ 10,511	$ 9,116	$ 1,395	15.3%
Percentage of net product sales	*52.7%*	*50.4%*			*50.4%*	*49.1%*		
European Markets	5,339	5,050	289	5.7%	5,050	4,703	347	7.4%
Percentage of net product sales	*22.3%*	*24.2%*			*24.2%*	*25.4%*		
Emerging Markets	2,296	1,665	631	37.9%	1,665	1,347	318	23.6%
Percentage of net product sales	*9.6%*	*8.0%*			*8.0%*	*7.3%*		
Asia Pacific	2,550	2,243	307	13.7%	2,243	2,039	204	10.0%
Percentage of net product sales	*10.7%*	*10.8%*			*10.8%*	*11.0%*		
Japan	1,131	1,384	(253)	(18.3)%	1,384	1,345	39	2.9%
Percentage of net product sales	*4.7%*	*6.6%*			*6.6%*	*7.2%*		
Total	$23,917	$20,853	$3,064	14.7%	$ 20,853	$18,550	$ 2,303	12.4%

Net Product Sales by Groups of Similar Products

The following table presents net sales for groups of similar products (in millions, except percentages):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	Variance in Percent	July 30, 2005	July 31, 2004	Variance in Dollars	Variance in Percent
Net product sales:								
Routers	$ 6,005	$ 5,498	$ 507	9.2%	$ 5,498	$ 5,406	$ 92	1.7 %
Percentage of net product sales	*25.1%*	*26.4%*			*26.4%*	*29.1%*		
Switches	10,833	9,950	883	8.9%	9,950	8,838	1,112	12.6 %
Percentage of net product sales	*45.3%*	*47.7%*			*47.7%*	*47.7%*		
Advanced technologies	6,228	4,634	1,594	34.4%	4,634	3,530	1,104	31.3 %
Percentage of net product sales	*26.0%*	*22.2%*			*22.2%*	*19.0%*		
Other	851	771	80	10.4%	771	776	(5)	(0.6)%
Percentage of net product sales	*3.6%*	*3.7%*			*3.7%*	*4.2%*		
Total	$23,917	$ 20,853	$3,064	14.7%	$ 20,853	$18,550	$ 2,303	12.4 %

Gross Margin

The following table presents the gross margin for products and services (in millions, except percentages):

Years Ended	AMOUNT July 29, 2006	July 30, 2005	July 31, 2004	PERCENTAGE July 29, 2006	July 30, 2005	July 31, 2004
Gross margin:						
Product	$15,803	$ 14,095	$ 12,784	66.1%	67.6%	68.9%
Service	2,944	2,576	2,342	64.5%	65.2%	67.0%
Total	$18,747	$ 16,671	$ 15,126	65.8%	67.2%	68.6%

The following table presents the gross margin for each theater (in millions, except percentages):

Years Ended	AMOUNT July 29, 2006	July 30, 2005	July 31, 2004	PERCENTAGE July 29, 2006	July 30, 2005	July 31, 2004
Gross margin:						
United States and Canada	$10,234	$ 8,784	$ 7,838	64.8%	66.1%	67.4%
European Markets	4,057	3,916	3,661	66.7%	68.8%	69.4%
Emerging Markets	1,682	1,267	1,019	67.9%	70.2%	70.3%
Asia Pacific	1,861	1,671	1,532	65.2%	67.2%	68.7%
Japan	913	1,033	1,076	70.7%	68.0%	73.9%
Total	$18,747	$ 16,671	$ 15,126	65.8%	67.2%	68.6%

Management's Discussion and Analysis of Financial Condition and Results of Operations

Research and Development, Sales and Marketing, and General and Administrative Expenses

Research and development (R&D), sales and marketing, and general and administrative (G&A) expenses are summarized in the following table (in millions, except percentages):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	Variance in Percent	July 30, 2005	July 31, 2004	Variance in Dollars	Variance in Percent
Research and development	$ 4,067	$3,322	$ 745	22.4%	$3,322	$3,192	$130	4.1%
Percentage of net sales	*14.3%*	*13.4%*			*13.4%*	*14.5%*		
Sales and marketing	6,031	4,721	1,310	27.7%	4,721	4,530	191	4.2%
Percentage of net sales	*21.2%*	*19.0%*			*19.0%*	*20.6%*		
General and administrative	1,169	959	210	21.9%	959	867	92	10.6%
Percentage of net sales	*4.1%*	*3.9%*			*3.9%*	*3.9%*		
Total	$11,267	$9,002	$2,265	25.2%	$9,002	$8,589	$413	4.8%
Percentage of net sales	*39.6%*	*36.3%*			*36.3%*	*39.0%*		

Interest and Other Income, Net

The following table presents the breakdown of interest and other income, net (in millions):

Years Ended	July 29, 2006	July 30, 2005	Variance in Dollars	July 30, 2005	July 31, 2004	Variance in Dollars
Interest income, net	$ 607	$552	$ 55	$ 552	$512	$ 40
Other income, net	30	68	(38)	68	188	(120)
Total	$ 637	$620	$ 17	$ 620	$700	$ (80)

Discussion of Fiscal 2006 and 2005

The following discussion of fiscal 2006 compared with fiscal 2005 should be read in conjunction with the section of this report entitled "Financial Data for Fiscal 2006, 2005, and 2004."

Net Sales

The increase in net product sales can be attributed to the continued gradual recovery in the global economic environment coupled with increased information technology-related capital spending in our enterprise, service provider, commercial, and consumer markets, and the acquisition of Scientific-Atlanta. Net sales for fiscal 2006 include Scientific-Atlanta's contribution for the five-month period subsequent to the acquisition date of $989 million, which consisted of $939 million in net product sales and $50 million in net service revenue. The increase in net product sales occurred across our four largest geographic theaters, with the United States and Canada and Emerging Markets theaters contributing 88.8% of the total increase. The majority of the increase in net product sales was related to higher sales of advanced technologies, which contributed 52.0% of the total increase, and higher sales of switches, which contributed 28.8% of the total increase. The increase in service revenue was primarily due to increased technical support service contract initiations and renewals associated with higher product sales that have resulted in a larger installed base of equipment being serviced.

Net Product Sales by Theater

The increase in net product sales in the United States and Canada theater was due to an increase in net product sales in all of our customer markets, led by strength in the enterprise, service provider and commercial markets, and the acquisition of Scientific-Atlanta, which contributed approximately $755 million of net product sales in this theater during fiscal 2006. However, sales to the U.S. federal government grew at a slower rate as compared to fiscal 2005. We believe our sales to the U.S. federal government remain subject to a possible realignment of government spending priorities and timing of budget rollouts, which could adversely affect these sales in future periods. The increase in net product sales in the European Markets theater was due to improvement in net product sales in Germany and France and the addition of the net product revenue from Scientific-Atlanta of approximately $90 million during fiscal 2006. Net product sales in the Emerging Markets theater increased primarily as a result of continued product deployment by service providers and growth in the enterprise and commercial markets. Net product sales relating to Scientific-Atlanta included in the Emerging Markets theater were approximately $65 million during fiscal 2006. The increase in net product sales in Asia Pacific occurred primarily as a result of continued infrastructure builds, broadband acceleration, investments by telecommunications carriers in our Asia Pacific theater, especially in China and India, and growth in the enterprise and commercial markets. Net product sales relating to Scientific-Atlanta included in the Asia Pacific theater were approximately $25 million during fiscal 2006. Net product sales in the Japan theater declined during fiscal 2006, as we faced economic and other challenges, as well as cautious spending from service providers.

Net Product Sales by Groups of Similar Products

Routers The increase in net product sales related to routers in fiscal 2006 was due to higher sales of all of our router categories. Our sales of high-end routers, which represent a larger proportion of our total router sales compared with midrange and low-end routers, increased by approximately $350 million over the prior fiscal year. High-end router sales for fiscal 2006 included approximately $200 million of net product sales related to products that were previously classified within switches and other product revenue categories during fiscal 2005. Our high-end router sales are primarily to service providers, which tend to make large and sporadic purchases. During fiscal 2006, sales of our midrange and low-end routers also increased. In fiscal 2005, we introduced the integrated services router. Sales of integrated services routers represented approximately 45% of our total revenue from midrange and low-end routers in fiscal 2006 as compared to approximately 20% of our total revenue from midrange and low-end routers in fiscal 2005.

Switches The increase in net product sales related to switches in fiscal 2006 was due to sales of local-area network (LAN) fixed switches and LAN modular switches. The increase in sales of LAN switches was a result of the continued adoption of new technologies, including Gigabit Ethernet and Power over Ethernet, by our customers. This has resulted in higher sales of our high-end modular switches, the Catalyst 6500 Series, and fixed switches, including the Cisco Catalyst 3560 Series and the Cisco Catalyst 3750 Series, as new technologies are deployed throughout the customers' networks from the core to the wiring closet. For fiscal 2006, approximately $150 million of net product sales previously classified within switches for fiscal 2005 was included in high-end router sales.

Advanced Technologies Scientific-Atlanta contributed net product sales related to advanced technologies of approximately $875 million during fiscal 2006, which increased sales of advanced technologies by approximately 19%. Unified communications, formerly enterprise IP communications, sales increased by approximately $350 million from fiscal 2005 primarily due to sales of IP phones and associated software as our customers transitioned from an analog-based to an IP-based infrastructure. Sales of security products increased by approximately $105 million during fiscal 2006 primarily due to module and line card sales related to our routers and LAN modular switches as customers continued to emphasize network security. Sales of storage area networking products increased by approximately $115 million during fiscal 2006 and wireless LAN product sales increased by approximately $135 million during fiscal 2006. Storage area networking and wireless LAN product sales increased primarily due to new customers and continued deployments with existing customers. Home networking product sales increased by approximately $180 million during fiscal 2006, primarily due to the acquisition of Scientific-Atlanta which contributed approximately $115 million of home networking product sales during fiscal 2006 and the growth of our wireless and wired router businesses. We experienced weakness in optical networking sales during fiscal 2006, with product sales increasing by approximately $5 million compared to fiscal 2005; approximately $65 million of these sales during fiscal 2006 related to Scientific-Atlanta. Our sales of optical networking products will no longer be included in our advanced technologies product category beginning in fiscal 2007 and instead will be included in the other product category. Sales of video systems products of approximately $695 million in fiscal 2006 were related to Scientific-Atlanta. Video systems include solutions and systems dedicated to enable video-specific systems, including both transmission and subscriber equipment, sold directly to service providers. Application networking services and hosted small-business systems, which were identified as advanced technologies in the second quarter of fiscal 2006, did not represent a significant amount of revenue for fiscal 2006.

Other Product Revenue The increase in other product revenue was due to the strength in sales of our cable and IP communications solutions to service providers and the contribution of net product sales related to Scientific-Atlanta. Net product sales for mobile wireless products previously classified in this category in fiscal 2005 was included in high-end router sales in fiscal 2006.

Factors That May Impact Net Product Sales Net product sales may continue to be affected by changes in the geopolitical environment and global economic conditions; competition, including price-focused competitors from Asia, especially China; new product introductions; sales cycles and product implementation cycles; changes in the mix of our customers between service provider and enterprise markets; changes in the mix of direct sales and indirect sales; variations in sales channels; and final acceptance criteria of the product, system, or solution as specified by the customer. In addition, sales to the service provider market have been characterized by large and often sporadic purchases, especially relating to our router sales and sales of certain advanced technologies. In addition, service provider customers typically have longer implementation cycles, require a broader range of services, including network design services, and often have acceptance provisions that can lead to a delay in revenue recognition. To improve customer satisfaction, we continue to focus on managing our manufacturing lead-time performance, which may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results.

Net product sales may also be adversely affected by fluctuations in demand for our products, especially with respect to Internet businesses and telecommunications service providers, price and product competition in the communications and information technology industry, introduction and market acceptance of new technologies and products, adoption of new networking standards, and financial difficulties experienced by our customers. We may, from time to time, experience manufacturing issues that create a delay in our suppliers' ability to provide specific components, resulting in delayed shipments. To the extent that manufacturing issues and any related component shortages, including those caused by any possible disruption related to lean manufacturing, result in delayed shipments in the future, and particularly in periods when we and our suppliers are operating at higher levels of capacity, it is possible that revenue for a quarter could be adversely affected if such matters are not remediated within the same quarter. For additional factors that may impact net product sales, see Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K.

Our distributors and retail partners participate in various cooperative marketing and other programs. In addition, increasing sales to our distributors and retail partners generally results in greater difficulty in forecasting the mix of our products and, to a certain degree, the timing of orders from our customers. We recognize revenue for sales to our distributors and retail partners based on a sell-through method using information provided by them, and we maintain estimated accruals and allowances for all cooperative marketing and other programs.

Net Service Revenue

The increase in net service revenue was primarily due to increased technical support service contract initiations and renewals associated with higher product sales, which have resulted in a larger installed base of equipment being serviced, and revenue from advanced services, which relates to consulting support services for our technologies for specific networking needs.

Gross Margin

The decrease in gross margin percentage compared to fiscal 2005 was primarily related to the acquisition of Scientific-Atlanta. Other factors contributing to the decrease in gross margin percentage were the sales mix of certain switching and routing products, and the effect of stock-based compensation expense under SFAS 123(R). These factors were partially offset by lower manufacturing costs related to lower component costs and value engineering, and other manufacturing-related costs and higher volume. The gross margin for each theater is based on information from the Company's internal management system. The gross margin percentage for a particular theater may fluctuate and period to period changes in such margin percentages may not be indicative of a trend for that theater.

Product Gross Margin

Product gross margin for fiscal 2006 includes the effect of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), amortization of purchased intangible assets, and inventory adjustments related to purchase accounting, which collectively reduced product gross margin percentage by approximately 0.5%. The remaining decrease in product gross margin percentage was due to the following factors. Changes in the mix of products sold decreased product gross margin percentage by approximately 2.5%, with 1.5% of this decrease being related to the inclusion of net product sales from Scientific-Atlanta and the remainder being due to sales of certain switching and routing products. Sales discounts, rebates, and product pricing decreased product gross margin percentage by approximately 1%. Lower overall manufacturing costs related to lower component costs and value engineering and other manufacturing-related costs increased product gross margin percentage by approximately 1%. Value engineering is the process by which production costs are reduced through component redesign, board configuration, test processes, and transformation processes. Higher shipment volume also increased product gross margin percentage by approximately 1.5%.

Product gross margin may continue to be adversely affected in the future by: changes in the mix of products sold, including further periods of increased growth of some of our lower-margin products; introduction of new products, including products with price-performance advantages; our ability to reduce production costs; entry into new markets, including markets with different pricing and cost structures; changes in distribution channels; price competition, including competitors from Asia and especially China; changes in geographic mix; sales discounts; increases in material or labor costs; excess inventory and obsolescence charges; warranty costs; changes in shipment volume; loss of cost savings due to changes in component pricing; impact of value engineering; inventory holding charges; and how well we execute on our strategy and operating plans.

Service Gross Margin

Service gross margin for fiscal 2006 includes the effect of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), which reduced service gross margin percentage by approximately 2.5% compared to fiscal 2005. Our service gross margin benefited from higher revenue on a relatively stable cost base. Our service gross margin from technical support services is higher than the service gross margin from our advanced services. Service gross margin will typically experience some variability over time due to various factors such as the change in mix between technical support services and advanced services, as well as the timing of technical support service contract initiations and renewals and the timing of our adding personnel and resources to support this business. Our revenue from advanced services may continue to increase to a higher proportion of total service revenue due to our continued focus on providing comprehensive support to our customers' networking devices, applications, and infrastructures.

Research and Development, Sales and Marketing, and General and Administrative Expenses

R&D expenses increased for fiscal 2006 compared to fiscal 2005 primarily due to higher headcount-related expenses reflecting our continued investment in R&D efforts in routers, switches, advanced technologies, and other product technologies; the effect of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R); and the acquisition of Scientific-Atlanta. R&D expenses include $346 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), and Scientific-Atlanta contributed $90 million of additional R&D expenses. We have also continued to purchase or license technology in order to bring a broad range of products to market in a timely fashion. If we believe that we are unable to enter a particular market in a timely manner with internally developed products, we may license technology from other businesses or acquire businesses as an alternative to internal R&D. All of our R&D costs have been expensed as incurred.

Sales and marketing expenses for fiscal 2006 increased compared to fiscal 2005 primarily due to an increase in sales expenses of approximately $1.1 billion. Sales expenses increased primarily due to an increase in headcount-related expenses, an increase in sales program expenses, and the acquisition of Scientific-Atlanta, which added approximately $30 million of sales expenses. Sales expenses also include stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) of $337 million during fiscal 2006. Marketing expenses include $90 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) during fiscal 2006. Scientific-Atlanta added approximately $20 million of marketing expenses.

G&A expenses for fiscal 2006 increased compared to fiscal 2005 primarily because of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R), and the acquisition of Scientific-Atlanta. G&A expenses include $115 million of stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) and Scientific-Atlanta contributed approximately $40 million of G&A expenses.

Our headcount increased by approximately 11,500 employees in fiscal 2006. Approximately 8,000 of the new employees were attributable to acquisitions we completed in fiscal 2006. Our headcount is expected to increase, as we continue to focus on the commercial market segment; additional sales coverage; growing and expanding our advanced technologies; our evolving support model; expanding our presence in the Emerging Markets theater; the next-generation service provider network build-outs; strengthening our product offerings in the consumer market; and providing more comprehensive solutions to our customers as they employ Internet solutions. As a result, if we do not achieve the benefits anticipated from these investments, our operating results may be adversely affected.

Stock-Based Compensation Expense

On July 31, 2005, we adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases based on estimated fair values. Stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for fiscal 2006 was allocated as follows (in millions):

	Amount
Cost of sales—product	$ 50
Cost of sales—service	112
Stock-based compensation expense included in cost of sales	162
Research and development	346
Sales and marketing	427
General and administrative	115
Stock-based compensation expense included in operating expenses	888
Total stock-based compensation expense related to employee stock options and employee stock purchases	1,050
Tax benefit	(294)
Stock-based compensation expense related to employee stock options and employee stock purchases, net of tax	$ 756

Stock-based compensation expense related to acquisitions and investments of $87 million for fiscal 2006 is disclosed in Note 3 and is not included in the above table. There was no stock-based compensation expense recognized for fiscal 2005 other than as related to acquisitions and investments.

Amortization of Purchased Intangible Assets

Amortization of purchased intangible assets included in operating expenses was $393 million in fiscal 2006, compared with $227 million in fiscal 2005. The increase was related primarily to additional amortization from the Scientific-Atlanta acquisition and an impairment charge of $69 million from a write down of purchased intangible assets related to certain technology and customer relationships due to a reduction in expected future cash flows. For additional information regarding our purchased intangible assets, see Note 3 to the Consolidated Financial Statements.

In-Process Research and Development

Our methodology for allocating the purchase price, relating to purchase acquisitions, to in-process R&D is determined through established valuation techniques in the high-technology communications industry. In-process R&D expense in fiscal 2006 was $91 million, compared with $26 million in fiscal 2005. See Note 3 to the Consolidated Financial Statements for additional information regarding the acquisitions completed in fiscal 2006 and fiscal 2005 and the in-process R&D recorded for each acquisition. In-process R&D was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed. The acquisition of Scientific-Atlanta accounted for $88 million of the in-process R&D during fiscal 2006, which related primarily to projects associated with Scientific-Atlanta's advanced models of digital set-top boxes, network software enhancements and upgrades, and data products and transmission products.

The fair value of the existing purchased technology and patents, as well as the technology under development, is determined using the income approach, which discounts expected future cash flows to present value. The discount rates used in the present value calculations are typically derived from a weighted-average cost of capital analysis and venture capital surveys, adjusted upward to reflect additional risks inherent in the development lifecycle. We consider the pricing model for products related to these acquisitions to be standard within the high-technology communications industry. However, we do not expect to achieve a material amount of expense reductions as a result of integrating the acquired in-process technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

For purchase acquisitions completed to date, the development of these technologies remains a significant risk due to the remaining efforts to achieve technological feasibility, rapidly changing customer markets, uncertain standards for new products, and significant competitive threats. The nature of the efforts to develop these technologies into commercially viable products consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technologies can meet market expectations, including functionality and technical requirements. Failure to bring these products to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets and could have a material adverse impact on our business and operating results.

The following table summarizes the key assumptions underlying the valuation for our purchase acquisitions completed in fiscal 2006 for which in-process R&D was recorded (in millions, except percentages):

	In-Process R&D Expense	Estimated Cost to Complete Technology at Time of Acquisition	Risk-Adjusted Discount Rate for In-Process R&D
KiSS Technology A/S	$ 2	$ 1	22.0%
Scientific-Atlanta, Inc.	88	93	17.0%
Other	1	1	22.0%
Total	$ 91	$ 95	

The key assumptions primarily consist of an expected completion date for the in-process projects; estimated costs to complete the projects; revenue and expense projections, assuming the products have entered the market; and discount rates based on the risks associated with the development lifecycle of the in-process technology acquired. Failure to achieve the expected levels of revenue and net income from these products will negatively impact the return on investment expected at the time that the acquisitions were completed and may result in impairment charges. Actual results from the purchase acquisitions to date did not have a material adverse impact on our business and operating results.

Interest Income, Net

The components of interest income, net, are as follows (in millions):

Years Ended	July 29, 2006	July 30, 2005
Interest income	$ 755	$552
Interest expense	(148)	—
Total	$ 607	$552

The increase in interest income was primarily due to higher average interest rates on our portfolio of cash and cash equivalents and fixed-income securities. The interest expense was attributable to the issuance of $6.5 billion in senior unsecured notes, and includes the effect of $6.0 billion of interest rate swaps. The effect of the interest rate swaps is to convert fixed-rate interest expense to floating-rate interest expense based on the London Interbank Offered Rate (LIBOR).

Other Income, Net

The components of other income, net, are as follows (in millions):

Years Ended	July 29, 2006	July 30, 2005
Net gains on investments in fixed income and publicly traded equity securities	$ 53	$ 88
Impairment charges on publicly traded equity securities	—	(5)
Net gains on investments in privately held companies	86	51
Impairment charges on investments in privately held companies	(15)	(39)
Net gains and impairment charges on investments	124	95
Other	(94)	(27)
Total	$ 30	$ 68

The other expenses of $94 million for fiscal 2006 consisted primarily of contributions of publicly traded equity securities and products to charitable organizations.

Provision for Income Taxes

The effective tax rate was 26.9% for fiscal 2006 and 28.6% for fiscal 2005. The effective tax rate differs from the statutory rate primarily due to acquisition-related costs, stock-based compensation expense, research and experimentation tax credits, state taxes, and the tax impact of foreign operations. The tax provision rate for fiscal 2006 included a benefit of approximately $124 million from the favorable settlement of a tax audit in a foreign jurisdiction.

On October 22, 2004, the American Jobs Creation Act of 2004 (the "Jobs Creation Act") was signed into law. The Jobs Creation Act created a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. In fiscal 2006, we distributed cash from our foreign subsidiaries and will report an extraordinary dividend (as defined in the Jobs Creation Act) of $1.2 billion and a related tax liability of approximately $63 million in our fiscal 2006 federal income tax return. This amount was previously provided for in the provision for income taxes and is included in income taxes payable.

For a full reconciliation of our effective tax rate to the U.S. federal statutory rate of 35% and further explanation of our provision for income taxes, see Note 11 to the Consolidated Financial Statements.

For fiscal 2006, the effective tax rate (including a 1.6% tax audit settlement benefit of $124 million) was 26.9%. Subject to the risks and uncertainties in estimating future effective tax rates, including as discussed in the sections entitled "Critical Accounting Estimates—Income Taxes" and Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K, we expect the effective tax rate for fiscal year 2007 to be lower than fiscal 2006 (excluding the effect of the tax audit settlement benefit) due to a relative decrease in earnings subject to taxation in countries that have higher statutory tax rates and a relative increase in earnings subject to taxation in countries that have lower statutory tax rates.

Discussion of Fiscal 2005 and 2004

The following discussion of fiscal 2005 compared with fiscal 2004 should be read in conjunction with the section of this report entitled "Financial Data for Fiscal 2006, 2005, and 2004."

Net Sales

The increase in net product sales for fiscal 2005 compared to fiscal 2004 was attributed to the continued gradual recovery in the global economic environment coupled with increased information technology-related capital spending in our enterprise, service provider, commercial, and consumer markets. The increase in net product sales occurred across all geographic theaters, with the United States and Canada and European Markets theaters contributing 75.6% of the total increase. The majority of the increase in net product sales was related to higher sales of switches, which contributed 48.3% of the total increase, and higher sales of advanced technology products, which contributed 47.9% of the total increase. The increase in service revenue was primarily due to increased technical support service contract initiations and renewals associated with higher product sales that have resulted in a larger installed base of equipment being serviced.

Fiscal 2005 had 52 weeks compared with 53 weeks in fiscal 2004, and we believe that this extra week may have had a positive impact on our sales in fiscal 2004. However, we were not able to quantify the effect of the slightly longer year on our revenue.

Net Product Sales by Theater

The increase in net product sales in the United States and Canada theater in fiscal 2005 was due to an increase in net product sales to all of our customer markets in the United States. However, our sales to the U.S. federal government, included within our enterprise market, experienced weakness due to, we believe, a realignment of spending priorities. Net product sales in the European Markets and Emerging Markets theaters increased primarily as a result of continued product deployment by service providers and growth in enterprise markets. Net product sales in the United Kingdom represented the largest increase in the European Markets theater. In Asia Pacific, net product sales increased primarily as a result of infrastructure builds, broadband acceleration, and investments by Asian telecommunications carriers. The growth was primarily in the service provider and enterprise markets in India, Korea, and Australia. However, we experienced weakness in our product sales to China. Net product sales in the Japan theater reflected ongoing economic and other challenges in the theater during fiscal 2005.

Net Product Sales by Groups of Similar Products

Routers The increase in net product sales related to routers in fiscal 2005 was primarily due to sales of high-end routers. Our sales of high-end routers, which represent a larger proportion of our total router sales compared with midrange and low-end routers, increased by $122 million over fiscal 2004. Sales of our midrange and low-end routers decreased by $30 million. In fiscal 2005, we introduced the integrated services router. Sales of integrated services routers represented approximately 20% of our total revenue from midrange and low-end routers in fiscal 2005. For the fourth quarter of fiscal 2005, sales of integrated services routers represented approximately 35% of our total revenue from midrange and low-end routers. Our high-end router sales are primarily to service providers, which tend to make large and sporadic purchases. In addition, our router sales in fiscal 2005 may have been impacted by new product introductions and increased competition from price-focused competitors.

Switches The increase in net product sales related to switches in fiscal 2005 was due to sales of LAN fixed switches and LAN modular switches. Our sales of LAN fixed and modular switches increased by approximately $1.2 billion, compared with fiscal 2004. The increase in sales of LAN switches was a result of the continued adoption of new technologies by our customers, resulting in higher sales of our high-end modular switch, the Cisco Catalyst 6500 Series, and fixed switches, including the Cisco Catalyst 3750 Series and Catalyst 3560 Series.

Advanced Technologies We experienced higher sales in fiscal 2005 in all of our advanced technologies compared with fiscal 2004. Home networking product sales increased by approximately $250 million, and were related to the growth of our wireless and wired router businesses. Unified communications sales increased by approximately $220 million primarily due to sales of IP phones and associated software as our customers transitioned from an analog-based to an IP-based infrastructure. Sales of security products increased by approximately $195 million primarily due to module and line card sales related to our routers and LAN modular switches as customers continued to emphasize network security. Optical networking product sales increased by approximately $150 million due to sales of the Cisco ONS 15454E and ONS 15454 platforms. Wireless LAN product sales increased by approximately $135 million. Sales of storage area networking products increased by approximately $105 million. Wireless LAN and storage area networking product sales increased primarily due to new customers and continued deployments with existing customers. Application networking services revenue increased by approximately $43 million.

Net Service Revenue

The increase in net service revenue was primarily due to increased technical support service contract initiations and renewals associated with higher product sales that have resulted in a larger installed base of equipment being serviced and revenue from advanced services, which relates to consulting support services of our technologies for specific networking needs.